

LITIGATION FUNDING: A BREAKTHROUGH FOR AVOIDANCE PROCEEDINGS UNDER IBC

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Litigation funding, sometimes also known as ‘third party funding’ is a mechanism to facilitate the recovery of claims by individuals and companies, especially those under financial stress, by funding the costs of legal proceedings. A litigation funder finances the cost of the litigation in exchange for a share of any recovery made through the proceedings, rather than the claimant paying the costs of the same.

This type of funding is often on non-recourse basis, meaning thereby that if the claim cannot be recovered, the claimant is not responsible for repaying the legal costs incurred by the litigation funder. As a result, the litigation funding agreement usually provides that the litigation funder bears most of the risk, whether it is the risk of losing a claim or even any damages imposed because of the litigation relating to the claim.

According to World Bank’s Ease of Doing Report¹, commercial contracts are resolved in around 1445 days in India, while in OECD (Organisation for Economic Co-operation and Development) countries it takes around 589.6 days. The report shows that the cost of litigation in India is approximately 31% of the claim value which is around 10% higher than in OECD countries. This often acts as a deterrent for claimants to initiate legal proceedings to recover a claim, which might have potential for being successful, but due to the prohibitive costs of pursuing the claim, they are discouraged from doing so.

LITIGATION FUNDING AND INTERIM FINANCE

The Insolvency and Bankruptcy Code, 2016 (Code/IBC) provides that the Insolvency Professional (IP) can raise funds for the corporate debtor (CD) through interim finance.² Interim finance can be crucial in resolving and restructuring a CD under corporate insolvency resolution process (CIRP), as it can provide much needed funds for the company's business operations to continue and meet other costs including litigation costs, subject to necessary approvals, as provided under the IBC. However, in general, it has proved to be a challenge for companies undergoing CIRP to access interim finance. One of the earliest instances where the IP was able to access interim finance was the CIRP of Alok Industries Ltd.³ Similarly, the IP was able to avail interim finance in the CIRP of Bharti Defence and Infrastructure Ltd.⁴

Interim finance is required to preserve value of a CD in a CIRP and facilitate the resolution process. Accordingly, the law provides that interim finance is paid in priority in a resolution plan in CIRP and under the waterfall mechanism in liquidation. As a facilitation measure, Reserve Bank of India (RBI) has, vide its circular⁵ on Prudential Framework for Resolution of Stressed Assets provided that interim finance may be treated as 'standard asset'.

Although, interim financing provides an opportunity for the CD to raise funds, but it is included in the CIRP or liquidation cost and since it is paid in priority, it does have an impact on the value of CD in a resolution plan or recovery in liquidation proceedings. Under litigation funding, the costs are borne by the litigation funder and the creditors have no direct impact under the scheme. Moreover, the IP can focus on his responsibilities without fretting about the outcome of the legal proceedings.

Advantages of Litigation Funding

Litigation funding gives an opportunity to the litigation funder to invest in a specific claim according to its potential with the possibility for investing in multiple claims at the same time. Litigation funding is usually on non-recourse basis, i.e., the cost is borne entirely by the funder. In the event of non-recovery from the claim, the parties disputing the claim are under no obligation to make any payments to the funder. The funder while pursuing a claim takes on a financial risk which could lead to irrecoverable loss suffered due to unsuccessful recovery of a claim, besides the costs of damages, if claimed by the counter party.⁶ However, for the claimant, this could be a viable option as he does not have to go through the financial risk of non-recovery of a claim. The litigation funder usually has its own risk assessment team which does risk assessment of each claim before deciding to take it up.

Litigation funding is best suited for the financiers with appropriate risk appetite as the yields from these types of investments are higher, with commensurate risks. The funders would invest in a claim only after getting fully satisfied on the probability of winning the litigation battle. It can be said to yield higher returns for the funders with relatively low investments, although the cost and time frame for recovery may be uncertain.

Litigation funding can have significant strategic benefits in addition to providing vital resources to

the claimants. In United Kingdom, some of the litigation funders have built such a reputation that their presence signals to a tribunal and the defendant, that an objective third party with significant expertise and experience in disputes is willing to put its own money on the line, because of the merits of the underlying claim. The likelihood of obtaining recovery brings about a negotiated settlement between parties. Moreover, a financially supported claimant is also less likely to feel compelled to accept a low settlement offer.

There is scope for litigation funding in avoidance proceedings under the IBC, as the IP can freely focus on keeping the CD as a going concern and running the processes of CIRP like invitation of claims, conduct of meetings of committee of creditors (CoC), invitation of expression of interest etc. The costs are being taken care of by the funders and the claims are processed by professionals who ensure that they are taken to a logical conclusion.

Litigation funding for avoidance transactions under IBC

In general, litigation funding is used in arbitration proceedings where the possibility of return on investment is huge. In CIRP, the claims that have potential for litigation funding are avoidance transactions⁷ including preferential transactions, under-valued transactions, extortionate credit and fraudulent transactions. The Code provides for the manner of treatment of avoidance transactions. There is a 'relevant period' for avoiding these transactions under the Code. However, for transactions which are fraudulent in nature, no such period is provided. The provisions for avoidance transactions under the Code ensure that transactions which have no commercial purpose and were performed just to benefit some creditors or to obstruct the insolvency or liquidation procedure, are set aside. The law aids in rectifying the situations where a property/asset is transferred merely to keep it out of the pool of assets available to a resolution applicant in CIRP or to be distributed among creditors in a CD under liquidation. However, the principles of avoidance, should be applied with caution so that lawful transactions which are consummated in the normal course of business are not reversed.

In the matter of *Anuj Jain Interim Resolution Professional for Jaypee Infratech Limited v. Axis Bank Limited and others*⁸ (Jaypee Infratech) the Hon'ble Supreme Court of India (SC) has clarified many aspects in respect of avoidance transactions under the IBC. The approach of the court has been to keep the value maximisation of assets of the CD in account while examining relevant provisions of the Code. The questions that arose before the SC were whether the transactions under reference were to be avoided for being preferential, fraudulent, or undervalued and whether the respondents could be recognised as financial creditors (FCs) based on mortgage created by the CD as a collateral security for the debt of its holding company. The SC, in its judgement, concluded that the impugned transactions had been for the benefit of the holding company, a related party of the CD and the transactions had the effect of putting such a related party in a beneficial position than it would have been in the event of distribution of assets being made in accordance with section 53 of the Code. Thus, the CD had given a preference to a related party in the manner laid down in section 43(2) of the Code. On the second issue, the SC opined that lenders of the related party, on the strength of the mortgages in question, may fall in the category of secured creditors, but such mortgages, are not a

facility or an advance to the CD nor towards protecting any facility or security of the CD. Therefore, it cannot be said that the CD owes them any 'financial debt' within the meaning of section 5(8) of the Code; hence, such lenders of the holding company do not fall in the category of the FCs of the CD.

The SC upheld the order of the Adjudicating Authority (AA) that cancelled the mortgage of immovable property without any consideration created by Jaiprakash Infratech Limited (JIL) to secure the financial debts of its parent company and CD, Jaiprakash Associates Limited (JAL), thereby ordering JAL to return the 858 acres parcel to JIL. The judgment has paved the way for the litigation funders to pursue the avoidance transaction claims, as a conclusive decision was taken on an avoidance transaction to restore the assets of the CD during the period of CIRP.

The law makes it mandatory for the IP to determine such transactions and take remedial measures, however, sometimes the real potential of a claim may not be considered by an IP due to paucity of funds and the uncertainty of getting a decision from the appropriate authority. Further, since there is no settled principle as to who will get the benefits of such claims if the avoidance application continues after the conclusion of the CIRP, the creditors are often disinterested in pursuing the claim. Litigation funding covers the cost of litigation and may also provide an arrangement where the creditors also benefit from the recoveries made from such proceedings.

In the recent past there have been some discussion about the recovery for FCs in CIRP.⁹ The total recovery of the Scheduled Commercial Banks is 45.5% under the IBC¹⁰, which is much better than the earlier mechanisms for resolution of stressed debt. However, there is a potential for better value maximisation of the CD under CIRP, if recoveries can be effected under the avoidance transactions.

LITIGATION FUNDING AND TIMELINES UNDER IBC

The Code endeavours to complete the insolvency resolution of the corporate and other debtors in a time bound manner. As provided in section 12 of the Code, the CIRP shall mandatorily be completed within a period of 330 days from the insolvency commencement date. The 348 CIRPs, which have yielded resolution plans by the end of March, 2021 took on average of 406 days for conclusion of process. The average period for resolution in 242 CIRPs completed by March, 2020 was 414 days, whereas 106 resolutions since then took an average of 563 days.¹¹

According to the report of the Insolvency Law Committee¹² (ILC), there would be no prescriptive timelines for the completion of avoidance transaction processes, and they may extend beyond the CIRP period. These cases may require evaluating many disputed transactions over a longer clawback period than CIRP, so they should have been allowed to continue beyond CIRP. It was suggested that IP shall continue with existing practice and remain as appropriate authority for carrying out preferential transaction investigations.

It appears from the experience till date that the applications for avoidance transactions are given lower priority, as in very few cases, AA has been able to arrive at a decision.¹³ Section 26 under the Code states that if any avoidance application is filed under section 25 of the Code, then it shall not affect the proceedings of CIRP. The application for avoidance proceedings is against the directors/

promoters/related parties of the CD and the resolution is for the CD. Therefore, the law and practice seem to indicate that the avoidance application proceedings and CIRP are two different and separate processes. However, some questions arise as to who will be the ultimate beneficiary of the amount that is recovered and who will handle the whole proceedings for avoidance applications filed, after the resolution plan of CD is approved by the AA. Also, the issues like, under which capacity IP will be dealing with these transactions after approval of resolution plan and who will bear the cost of such litigation is still to be addressed in a conclusive manner.

In the case of *M/s. Venus Recruiters Pvt Ltd*¹⁴, the question arose that whether an application filed under section 43 for avoidance transaction can survive beyond the conclusion of CIRP. Hon'ble Justice Pratibha Singh of Delhi High Court (HC) adjudged that the avoidance transaction applications which are pending on the date of approval of resolution plan cannot be allowed to continue after the resolution plan gets approved under section 31 of the Code. It was also held that the avoidance application is intended to benefit creditors of the CD in its pre- insolvency state, not the CD in 'new avatar' after the resolution plan is approved.

The experience till date is that CIRP has been susceptible to the delays at the stage of admission as well as due to litigation during CIRP.¹⁵ The Hon'ble HC, in the *Venus Recruiters Pvt. Ltd.* case was of the opinion that, with the completion of CIRP, the application of avoidance transaction will also cease. This implies that the applications of avoidance transaction must be completed in a time bound manner. Litigation funding for avoidance transactions could be an efficient way to proceed with such claims, as it would bring in professionals with domain expertise to process and pursue such claims, leaving the IP free to pursue the core processes of CIRP.

The promulgation of Insolvency and Bankruptcy Code (Amendment) Ordinance, 2021 introduced pre-packaged insolvency resolution process (PPIRP) for corporate persons classified as micro, small and medium enterprises (MSMEs), and the process is to be completed within 90 days. The shorter window would require quick decisions to be taken regarding determination and necessary action in respect of avoidance proceedings where there could be benefits of litigation funding from professionals. Secondly the MSME sector in general has large dues from the larger corporates, many MSMEs have also got poor recoveries from CIRPs of large corporates. This has led to litigation and public outcry leading to delay in implementation of resolution plan, even where a resolution plan has received the approval of the AA. Litigation funding could enable MSMEs recover their dues even outside insolvency proceedings.

LITIGATION FUNDING- INTERNATIONAL SCENARIO

Litigation funding was generally limited to common law jurisdictions like United Kingdom (UK), United States and Australia until recently, but it has seen a significant expansion in recent years. Countries such as Germany, Hong Kong and Singapore have also taken measures to remove legal impediments to Third Party Funding. These jurisdictions have clearly recognised the benefits of the concept, which includes a more effective recovery mechanism, and easier access to justice.¹⁶

However, regulation in litigation funding is also a necessity. In UK, for example, a code of conduct for litigation funders is in place, requiring them to act properly, refrain from withdrawing such funds except under particular conditions, keep confidentiality, and not seize control of the litigation or settlement negotiations. The practice in the UK is keeping the responsibilities of funders, claimants, and their lawyers separate. The Association of Litigation Funders (ALF), an independent group mandated by the Ministry of Justice with delivering self-regulation of disputes resolved primarily through litigation proceedings in England, was established in November, 2011.

In UK, litigation funders can either acquire the claims completely from the Insolvency Practitioner or provide services for a fee plus a percentage of the proceeds. The purchase of claims can benefit both the funder and the IPs, as it gives the funder control over the claims and allows the IPs to utilise the cash to examine other prospective claims.¹⁷

Many firms in UK are investing in insolvency cases. Manolete Partners Plc¹⁸ is one such leading UK firm that finances the litigation in claims related to insolvency proceedings to maximise recoveries for creditor estates while also taking on all the risk. The firm has invested in over 600 claims and approximately 388 cases have been completed. About 459 claims out of total claims were purchased via assignment and 159 were funded which shows that assignment model has been popular in UK. As per an advertisement put out by the firm, it claims a very high success rate in all the cases it has funded.

BUSINESS MODEL OF THE LITIGATION FUNDER

Dedicated financiers perceive litigation funding as part of new business opportunities, and these Litigation Funds, in the anticipation of high-stakes legal procedures, provide funding to litigation expenses, and reap the benefits of the proceedings.¹⁹ The avoidance transaction claims in CIRP may provide an opportunity to these financiers since the claims can be separated from the CIRP and can progress independently.

In the litigation funding model in insolvency proceedings, the funder makes a three-way partnership with the IP and the lawyers so that the claim is pursued and resolved quickly. Whether the funder funds the IP or has taken the assignment of the claims, the IP stays closely related to the claim. The agreement between the funder and the IP can be simple purchase or funding agreement. The defendant is intimated about the claim so that they may be made aware of the fact that the claim is funded by the third party. In UK, where litigation funding is common in insolvency proceedings, many cases are settled on commercial terms, and few also go to trial stage.²⁰

While evaluating a claimant's litigation funding request, the funder usually looks at six key factors which includes the merits of the claim, credentials of the claimant, litigation budget, claimant's legal representative/law firm, expected damages and the mode of recovery.²¹ Funders like to invest in situations that can be resolved quickly. They are unwilling to participate in instances that may result in a lengthy court battle because of the uncertainty factor and therefore the risks to a favourable outcome.

The scope of the funder's scrutiny will be determined primarily by the type of case, the importance of the action, the complexity of the issues involved, the preparation of the diligence papers, and litigation counsel's ability to present its position succinctly.²²

The funder will examine whether the parties are likely to act reasonably when negotiating a settlement offer based on how interested the claimant is in the dispute. To comprehend the economics of the plan and determine whether the claimant's and its law firm's interests are sufficiently aligned, the funder needs to assess the experience of the legal team working on the case and the terms of the agreement with the claimant.

Litigation funding is a pre-determined amount of money that will be used to pay for legal fees and expenses. If the estimated budget is exceeded, the funder may rely on the claimant or counsel depending on the agreement between the parties.²³ Also, the size of a prospective award must be sufficient to give the funder with a return that equals the investment risk while also covering the actual costs of litigation.

CHALLENGES FOR FINANCIERS UNDER IBC

The IBC provides that the IP must form an opinion whether any avoidance of transaction have taken place, after which he makes an application to the AA under section 26 of the Code. It needs to be examined whether the IP can assign the claim to the litigation funder, as the responsibility to file the application lies with the IP. Therefore, this is a challenge for the financiers as there is no certainty of assignment of the claim under the existing provisions of the IBC. However, the IP could have an arrangement, where, after examining its legal validity, the litigation funder can process and fund the litigation related to such claims, in lieu of share of proceeds from such transaction which can be paid in advance for the benefit of the creditors.

The beneficiaries of litigation funding may have an apprehension that once the funds are provided to the CD, the funder firm may wish to appoint its own lawyers to handle the claim. To rule out such an apprehension, the litigation funder usually provides in the agreement itself that, it only must be updated on the case progress and be consulted on big disbursement expenditures²⁴, with the case being handled by a professional legal team. Further, if the funder firm were to have its own legal counsel in each case, it would need a staff almost the size of a major law firm, and the business wouldn't be economically viable. The experience in UK is that in most cases, the existing legal team continues the proceedings under the supervision, where required of the litigation funding team.

The reputation of a professional funder is just as crucial as the assets he manages.²⁵ Another apprehension is that a funder may rely on its financial strength to finance even unmeritorious claims. If the funder finances unmeritorious claims, the funder will lose money and the funder's promoters will lose faith in the funder's ability to select claims and run a viable, lucrative, and long-term business.

The biggest challenge that litigation funder might face is when it makes upfront payment against the claims, besides the risks of non-recovery of claim, it could also be subject to scrutiny where there are windfall gains against such claims. A way to resolving such issues could be to provide in the agreement with the IP, a clause that some benefit be passed on to the creditors or the CD, in cases where the recovery is substantially more than the initial pay out to creditors.

Potential of Litigation Funding in India

Shortage of resources triggered by the COVID-19 pandemic has already made business operations for industries in certain sectors extremely arduous, which are combating shrinking balance sheets and a reduction in the available credit. These factors could increase opportunities for litigation funding and for funders to help businesses pursue their litigation claims through the ‘third-party funding’ route.

In India, third-party litigation funding is permitted under the Civil Code of Procedure (CPC), 1908 in some states (for example, Madhya Pradesh, Maharashtra, Gujarat, and Uttar Pradesh), by the respective state amendments to Order XXV Rules 1 and 3 of the CPC. Therefore, we can see that the authorisation for third-party funding is there from CPC in India. Further, there is no express prohibition under any legislation for the same.

In the recent past, two significant examples of third-party fundraising prompted corporate finance experts to consider litigation funding as an alternative source of funding: arbitration award monetisation in Hindustan Construction Company and Patel Engineering. The major infrastructure companies in India are dealing with stretched receivables and large pending claims²⁶, litigation finance will surely assist them in resolving these issues.

As per the report of ILC²⁷, there are issues regarding the funding for expenditure incurred for litigation related to avoidance transactions under the IBC in India and analysed some ways for funding that are prevalent globally like debtor’s estate, state funding, appointment of contingency counsel, funding by creditors and third parties. The committee examined all aspects and stated in its report that the extant legal provisions do not prohibit third-party litigation funding in India and accordingly funding for such litigations may be left to the market. It therefore concluded that no legal change is required in this regard.

The Indian Association for Litigation Financing (IALF) incorporated on February 11, 2021 by practitioners, law firms, and third-party funders, provides a glimmer of hope to this source of funding. The association aims to self-regulate litigation funding in India and disseminate information about it for the people to learn the business of litigation finance. This is the first step towards setting up the regulatory framework for litigation funding in India. The working group of IALF comprises Phoenix Advisors, Omni Bridgeway, Singularity Legal, FTI Consulting and Grant Thornton. According to the working group, the biggest beneficiary of the third-party financing would be MSMEs. The first meeting of the working group of IALF was held in April, 2021 where the future course of the organisation and first 100-day plan for IALF was discussed.

CONCLUSION

India needs a robust regulatory structure that focuses on litigation funders' disclosure, credentials, and conduct. Such legislative and regulatory safeguards are necessary to ensure that there is an equitable and fair settlement procedure for parties receiving litigation funding and is also able to withstand judicial scrutiny.

India still has a long way to go in terms of realising the potential of litigation funding. However, many stakeholders are looking at this very seriously to meet the costs of litigation involved in recovery of a claim. A good business model can help financiers become interested in the project. With the implementation of the IBC, jurisprudence on a variety of issues has developed within a very short span of time. It is certain that we are not far behind in getting better avenues for funding of litigation costs, especially for avoidance proceedings under the IBC. This could lead to better outcomes under avoidance proceedings which in turn could lead to maximisation of the value of the CD, one of the objectives of the IBC.

NOTES

¹ World Bank's Ease of Doing Business Report, 2020.

² Section 5(15) under Chapter 1 Part II, IBC.

³ CP(IB) 48 of 2017.

⁴ MA 170/2018 CP292/I&B/NCLT/MAH/2017.

⁵ Prudential Framework for Resolution of Stressed Assets, June 7, 2019.

⁶ Singh A. (2021), "Funding lawsuits- For a piece of Justice", *Indian Legal*, 02 January.

⁷ Section 26, IBC.

⁸ Civil Appeals 8512-8527 of 2019.

⁹ IA 196 of 2021.

¹⁰ IBBI Quarterly Newsletter, January- March, 2021.

¹¹ *Ibid.*

¹² Report of Insolvency Law Committee, February, 2020, p. 20.

¹³ IBBI (2019), Discussion paper on "Corporate Liquidation Process for Corporate Persons along with Draft Regulation, 2016", 27 April.

¹⁴ W.P.(C) 8705/2019 & CM APPL. 36026/2019.

¹⁵ *Supra* Note 12, p. 21.

¹⁶ Limpiner A. and Simons W. (2019), "A Practical guide to litigation funding", Woodsford Litigation Funding Insight.

¹⁷ Wilkins S. and Ganguly R. (2020), "Litigation funding in Insolvency", Digest South Square, 16 March.

¹⁸ Manolete Partners PLC.

¹⁹ Fuqua R. (2021), "How Litigation Funders Have Improved the Quality of Settlements in America", Harvard Negotiation Law Review, June, 2021.

²⁰ <https://www.manolete-partners.com/how-we-work/the-manolete-method>.

²¹ ICCA (2018), The ICCA-Queen Mary Task Force on Third-Party Funding in International Arbitration, pp. 20-23.

²² Zhang B. (2021), Third Party Funding for Dispute Resolution, Springer Nature Publications, pp. 195-196.

²³ Makatsch T and Baurle R. (2021), "Funding and costs from the Claimants perspective", *Global Competition Review*.

²⁴ Nasta M (2016), "Third party litigation funding in insolvency", *Financier Worldwide*, 10 September.

²⁵ Eccles R. et. al. (2007), "Reputation and its Risks", *Harvard Law Review*.

²⁶ PIB Press Release on reforms passed by Cabinet Committee on Economic Affairs, August 31, 2016.

²⁷ *Supra* Note 12, pp. 87-89.